UK Pension Reform – One Year On

"With freedom comes responsibility"
– Eleanor Roosevelt

Standard Life Investments

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Introduction

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Reforms implemented in 2015 provided UK pension savers with significantly greater freedom of choice. In particular, retiring defined contribution (DC) pension scheme members are no longer forced to buy an annuity.

As we assess the various benefits and risks of the new freedom, it is clear that the implications for pension savers and scheme providers are profound. The reforms have prompted changes in savings strategy, especially the investment planning of DC schemes and traditional lifestyle strategies. For individuals, the expanded choices at-retirement and post-retirement bring more options, but also more responsibility.

In this article, we assess some of the developments that have occurred and compare DC savers' actions with those expected when the changes were announced. In addition, we discuss what scheme providers are doing to ensure that pension savers utilise their pension freedom in a manner that best suits their individual circumstances*.

*The Defaqto research referred to in this document was specially commissioned by Standard Life. The sample comprised around 200 financial adviser firms of diverse size and included those with and without adviser networks. Additionally, we make use of Standard Life's own internal observations. Standard Life is the largest bundled provider in the UK and we therefore believe it is fair to say the company's own experience provides a reasonable proxy for the DC market.

The new landscape

Previously, DC schemes targeted a 'one size fits all' approach to retirement funding for their members. This aimed to provide a combination of tax-free cash and an annuity. Now, there is widespread recognition that individual members may have different post-retirement needs. Schemes are responding to calls for greater flexibility by changing their default savings strategies. To this end, they are offering different routes to the retirement 'landing site' – that is, the asset allocation best suited to a member's needs at the end of working life.

Saving while working is very much a group experience where a default approach can be implemented within a specific charge cap cost. By contrast, the way in which savings are invested and spent in retirement is very much an individual matter, reflecting personal circumstances and objectives. Bespoke investment advice about retirement can be of great value and therefore comes with additional cost.

What did we think would happen?

There were a number of general expectations regarding how DC savers would respond to pension freedom.

- There was concern that many DC savers over the age of 55 (i.e. those who can now take advantage of pension freedom) would rush to access their pension savings.
- We expected those with very small DC pots to take all of their monies as quickly as possible (given the favourable tax treatment).
- We expected that members with larger pots would take their tax-free cash and either buy an annuity or enter a drawdown solution. Most were expected to choose drawdown.

What is actually happening?

We have made the following observations.

- There has been no huge rush by scheme members to raid their pension savings. More than 90% of members over 55 have, as yet, done nothing and continue to save to fund their retirement spending as before.
- Of those who have taken action, a number of trends have emerged.
  - Those with very small DC pots have generally taken all of their monies immediately.
  - Members with larger pots have taken their tax-free cash. Many have done this to meet some specific goal but have no intention of spending their remaining assets in the near term.
  - As expected, relatively few members have purchased annuities. Recent research conducted by Defaqto suggests that less than 15% of advised clients have opted for an annuity. There is early evidence that this figure may be lower still for non-advised members taking benefits.
  - Drawdown appears to be emerging as the more popular option for those members taking benefits. However, members are not necessarily using their pension savings as a direct replacement for the regular income stream provided by an annuity. Instead, many take irregular withdrawals as and when required. This is particularly true for members with relatively small pots.
  - Those members with larger pots are more likely to have an adviser. Of these, the Defaqto research suggests a larger proportion is using pension savings to create a regular income.
- Almost 80% of financial advisers have seen more demand for 'at retirement' advice. However, there is evidence that a significant number of DC savers are not seeking guidance. This could be for a number of reasons. For many members, professional help is highly advisable – drawdown is potentially complex and advisers can provide added value services (such as tax planning, withdrawal management and legacy planning) that cannot be obtained by going to a provider direct.

  However, for others, the cost of advice relative to the size of the pension pot makes it unaffordable. For instance, there are those with relatively simple needs (having no regular withdrawals to manage and for whom tax and legacy are less of an issue). Or members may have just one use for their tax-free cash at the present time (such as paying down debt). These individuals may take advice at a later date if/when their needs become more complex.
- There have been relatively few switches from defined benefit (DB) schemes to DC, no doubt influenced by the FCA's position on this issue.
- Almost all the DC schemes we spoke to are looking for external providers to deliver solutions for their retiring members, rather than assuming responsibility for the post-retirement approach themselves.

Making post-retirement savings last

We summarise below our initial thinking on how retirees might make use of their post-retirement savings. Judging by what we have seen in the first year since the reforms we believe that, for the most part, our expectations have been realised.

Purpose	Advantages/disadvantages to consider
Lump sum unplanned	Capital growth and risk considerations Instant access to capital
Lump sum planned	Capital growth and risk considerations Limited access to capital
Regular expenditure discretionary	Variable income Capital growth and risk considerations Instant access to capital
Regular expenditure basic	Steady income High probability of payment

The relatively large number of members taking tax-free cash while not selecting a plan to provide regular income suggests a number of behaviours may be evolving.

- Members view their pension assets as part of their overall wealth and are simply using a proportion of it to meet some financial goal. However, this does not mean that they consider themselves as having moved into a decumulation phase. They may be settling debts, paying down mortgages early or helping children/parents meet financial needs (e.g. university or care costs) while continuing to work and save.
- Members do not see their DC pots as the main source of regular income in retirement and instead are using the assets for lump sum spending only. The current cohort of DC members likely belongs to a generation that also has DB benefits which (along with state benefits) will provide regular essential income. DC pots may then be viewed as a source of funding for discretionary or 'big ticket' spending that may be more ad hoc in nature. They may also view the DC pot as a pool of assets that can be passed on to dependents in a relatively tax-efficient way. Therefore, they choose to rely on other assets to fund regular expenditure.

How are things likely to develop?

While it is interesting to look at what people have done so far, we should bear in mind that we are only a year into a completely new world of pension freedoms. Over time, the trends we see now may change or disappear.

In years to come, many DC retirees with larger pots will still tend to have DB benefits which may even comprise the bulk of their pension provision. Hence, the relatively low numbers of drawdown participants taking a regular income from their DC savings may persist. In the longer term, as the number of retirees with significant DB assets falls, we may see a reversal of this trend, with members seeking regular income from their DC pots.

Taking a step back, our main observation is that the picture is complicated. Members' choices over the use of their assets are personal to them and are driven by their individual circumstances, life goals and financial preparedness for retirement.

We have previously written at length about the benefits of lower-volatility growth solutions for those investors requiring regular income. For the DB/DC group, lower volatility is likely to remain important. However, there may be a need for multiple investment strategies with a range of objectives to meet differing return and risk requirements, levels of priority and timescales.

The importance of choice

As activity over the first year has highlighted, the pension freedoms allow DC members greater choice in the use of their pension savings – and that in itself impacts on the accumulation/savings journey in the years preceding retirement.

For DC members considering taking their pot as cash, a gradual de-risking from growth assets is appropriate as retirement nears. For those intending to take an annuity, the current approach of moving assets to bonds continues to be relevant.

However, members who choose drawdown will probably continue to require exposure to growth assets post-retirement. As a result, their accumulation strategy needs to be different. To avoid the market-timing risk associated with a shift in risk profile, these members need to keep a fairly constant exposure to growth assets as they move from working life to retirement. Within this group, some will want a regular drawdown and others will effectively use the pension pot as an extra source of wealth. Varied approaches are needed to adequately accommodate these goals.

The importance of member engagement and support

To get the most out of their pension savings, members need to be more engaged and better supported. This will help them make informed decisions and ensure their retirement journey matches their objectives and preferences.

In our experience, most DC plans do not want to assume responsibility for providing a post-retirement investment option. However, they may wish to consider how to support their members in the years before retirement. This could be accomplished through communication, tools, seminars, access to advice or even the choice of investment options they offer their members. While most plans do currently offer choice, the options are typically confined to a single 'packaged' default versus a selection of funds from which members can build their own portfolios.

Historically, therefore, most members have tended to choose the default investment option because they usually lack the knowledge and/or confidence to make complex investment decisions. Thus, the choices on offer give little guidance on how to tailor the accumulation journey to post-retirement needs. In future, scheme providers may wish to consider implementing an 'investment choice architecture' to assist those members with minimal investment knowledge or experience.

Our own experience suggests that members will generally fall into one of three broad groups in terms of how they engage with investments.

- **Do it for me –** these members tend to be the least engaged and/or the most nervous about making investment decisions. Generally, they look for an investment option that avoids doing so. In accumulation, this group is therefore likely to stick with the scheme default.
- **Help me do it –** these members are likely to be more engaged. They may want greater control over, for instance, the degree of risk taken or the destination of their lifestyle profile (cash, annuity, drawdown) in order to structure their investments to their individual needs. However, their engagement will not extend to fund picking or portfolio management. Rather, they just want to know their investments are being managed to their requirements. This group may benefit from a range of easy choices between packaged investment options that allow them to tailor their journey without taking responsibility for ongoing portfolio management.
- **Let me do it –** these members are highly engaged. They know exactly what they want from their investments and are willing to make investment decisions. This group is likely to want a range of options from which to create bespoke portfolios.

DC schemes – adapting from a group mindset to an individual mindset

A number of DC schemes have already recognised the changing nature of members' post-retirement behaviour, moving from a default 'annuity glidepath' to one that transitions to a relatively low-risk, multi-asset approach.

As we have stated, DC schemes are generally unwilling to take responsibility for delivering the post-retirement experience themselves. They do, however, want to be sure they discharge their governance responsibilities by providing members with guidance and access to future-proofed solutions. Therefore, in appointing an external provider, DC trustees are keen to ensure that members are offered:

- an appropriate choice architecture, with post-retirement options suitable for 'do it for me'/'help me do it'/'let me do it' investor types
- ongoing support (helplines/website) to help ex-members make decisions about how they will use their pension pot in retirement
- high levels of governance.

The DC retirement solution – a suite of approaches

We believe the DC retirement solution of the future comprises a broad suite of service and investment approaches, tailored to the various financial needs and investment knowledge of retiring DC members. Solutions offering high degrees of flexibility alongside effective engagement strategies are likely to be winners in this market place. Price, while important, will not be the over-riding issue that it has become in the accumulation phase. Indeed, value for money will be assessed in different ways.

Summary

One year into the reformed pension landscape, our expectations have for the most part been realised. However, the picture is complicated and current trends may well change in future. From the perspective of DC scheme providers, flexibility and engagement are crucial objectives in ensuring individual member needs can be accommodated.

If you would like to find out more, please speak to your usual contact at Standard Life Investments, or visit our website at www.standardlifeinvestments.com.

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